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## Foreign currency translation: Issues and answers, An implementation guide to FASB Statement no. 52

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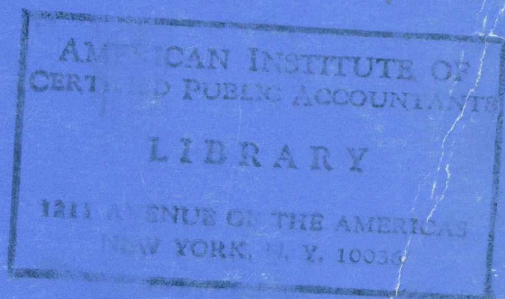
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USA

# Foreign Currency Translation— Issues and Answers



**An Implementation Guide to FASB Statement No. 52**

**January 1982**

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# **Foreign Currency Translation— Issues and Answers**

**An Implementation Guide to FASB Statement No. 52**

**January 1982**



## PREFACE

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In December 1981, the Financial Accounting Standards Board (FASB) issued Statement No. 52, *Foreign Currency Translation* (Statement), which supersedes Statement No. 8, *Accounting for the Translation of Foreign Currency Transactions and Foreign Currency Financial Statements*. Our booklet, "Foreign Currency Translation," also issued in December 1981, describes the significant changes in the objectives of and methodology for foreign currency translation embodied in the Statement and provides illustrations of the application of the Statement's provisions.

Although adoption of the Statement is not required until fiscal years beginning on or after December 15, 1982, earlier application is encouraged, and managements are faced with the decision as to when to adopt the new Statement. Since the Statement was issued, we have received numerous questions concerning the application of the Statement's provisions both from enterprises that are adopting the Statement in their 1981 financial reports and from enterprises that are considering adopting the Statement in 1982. Because of the interest expressed by senior operating and financial executives, we have published this additional booklet to assist those individuals in addressing implementation issues that we anticipate will be encountered in the initial application of the provisions of the Statement.

Our responses to the questions included in this booklet represent views developed in specific fact situations and are not intended to be definitive statements of policy applicable to all circumstances. These questions and responses should be used as a supplement to, rather than a substitute for, a thorough reading and understanding of the Statement.

In many of the areas covered in the following questions and responses, such as the definition of a substantially complete liquidation or the determination of the effectiveness of a hedge, the guidance of the Statement is not specific. In other areas, such as the determination of the functional currency, the Statement specifically provides that management judgment will be required. Although we believe that responses presented in this booklet are consistent with the concepts underlying the Statement, as we gain experience with the application of the provisions of the Statement, such experience may affect the guidance contained in some of the responses. Accordingly, when addressing these issues and answers in your specific fact situations, consultation with your local Deloitte Haskins & Sells representative would be advised. A listing of our domestic and international offices is included at the back of this booklet for your convenience.

## DIFFERENCES BETWEEN STATEMENTS NO. 8 AND 52

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### Statement No. 8

### Statement No. 52

#### *Foreign Currency Financial Statements*

Measure in dollars and in conformity with U.S. GAAP



Single entity/single unit of measure approach



Temporal method



Translation adjustments included in the determination of income, i.e., the exchange rate change triggers realization.

Intercompany transactions and highly inflationary economies were treated in the same manner as any other transactions and economies.

Measure in functional currencies and in conformity with U.S. GAAP



Multiple entity/functional currency approach



Remeasurement process/current rate method



Remeasurement adjustments included in the determination of income and Translation adjustments included in a separate component of equity until realized through sale or liquidation of the underlying investment.

Multiple entity approach requires special provisions for intercompany transactions; functional currency approach requires special provisions for highly inflationary economies.

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#### *Foreign Currency Transactions*

(No significant changes except for intercompany transactions discussed above and hedging transactions discussed below.)

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**Statement No. 8****Statement No. 52*****Hedging******What Could Be Hedged***

Foreign currency commitments as long as three conditions were met:

1. Life of forward contract used as a hedge extended from date of commitment to anticipated transaction date or later;
2. Forward contract used as a hedge denominated in the currency of the commitment and for an amount equal to or less than the commitment; and
3. Commitment was firm and uncancelable.

***What Could Be Used as a Hedge***

Forward exchange contracts denominated in the same currency as the commitment.

***What Can Be Hedged***

Foreign currency commitments as long as two conditions are met:

1. The foreign currency transaction is designated as and is effective as a hedge—precise matching of dates or amounts of currencies is no longer required; and
2. Foreign currency commitment is firm.

In addition, new standard permits hedging of net investments in a foreign entity as long as the transaction is designated as and is effective as a hedge.

***What Can Be Used as a Hedge***

Foreign currency transactions of which forward exchange contracts is just one type, and may be denominated in a currency for which the exchange rate generally moves in tandem with the exchange rate of the functional currency.

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## Determination of the Functional Currency

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The *functional currency* of an enterprise is basically a matter of fact, but in some instances the observable facts will not clearly identify a single functional currency. For this reason, the FASB has developed general guidance on economic indicators to be considered by management in determining the functional currency. The salient economic factors to be considered (presented in Appendix A to Statement No. 52), both individually and collectively, include indicators of cash flow, sales price, sales market, expense, financing, and intercompany transactions. In those instances in which the indicators are mixed and the functional currency is not obvious, management's judgment is required to assess the facts and circumstances of a particular foreign entity's operations, and to determine the functional currency that best meets the objectives set forth in the Statement for foreign currency translation. We would expect that in situations where the indicators are mixed, management's judgment will be determinative in selecting the appropriate functional currency provided that such judgment is not contradicted by the facts. Once that decision is made, the determination of the functional currency should be adhered to consistently unless the facts and circumstances change significantly. Previously issued financial statements should not be restated for any change in the functional currency.

In the questions discussed below, only one or two economic factors are presented; a complete evaluation of other indicators, individually and collectively, would be necessary to determine the appropriate functional currency in each situation. The economic indicators described generally point to the local currency or to the reporting currency as being the functional currency, but the indicators are not, by themselves, determinative.

**Question No. 1: Cash Inflows versus Cash Outflows.** If most of a foreign entity's cash inflows are denominated in one currency and most of its cash outflows are denominated in another currency, would the currency of cash inflows be the functional currency?

**Response:** Appendix A to Statement No. 52 presents a list of salient economic factors, *all* of which must be considered in determining an entity's functional currency. The Statement does not provide any guidance that would suggest that one factor is more important than any other factor. Accordingly, the facts presented alone do not provide sufficient information to determine the appropriate functional currency. Although the currency inflow denomination is important, it is not necessarily more important than the currency outflow denomination.

For example, consider the following situation:

A foreign entity operates as a ship builder, constructing ships in the foreign country to customer specifications. The ship building industry in



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general has suffered recently as a result of economic factors; builders have experienced contract cancellation rate increases due to customers being unable to honor firm commitments.

The foreign entity's financial statements and accounting records are prepared and maintained in the local foreign currency. Operating costs and ship construction costs are also denominated in the local foreign currency. Sales are made to customers in various countries largely denominated in U.S. dollars. At any point in time the foreign entity has a significant amount of customer accounts receivable denominated in U.S. dollars. A typical firm sales contract requires that the customer pay 10 percent down (in U.S. dollars) at the time the contractual agreement is made. To finance ship construction, the foreign entity borrows funds denominated in U.S. dollars primarily because its sales have been denominated in U.S. dollars. Ships constructed for which the intended customer cancels are operated by the foreign entity until another customer is found.

Certain factors in this situation support designation of the U.S. dollar as the functional currency while other factors support designation of the local foreign currency as the functional currency.

Factors supporting the U.S. dollar as the functional currency include:

- Sales are largely denominated in U.S. dollars
- Financing ship construction is primarily by U.S. dollar denominated obligations
- Cash inflows from ship sales are principally in U.S. dollars
- Sales are made on a worldwide basis and there is not an active local sales market.

Factors supporting the local foreign currency as the functional currency include:

- Ships are constructed in the foreign country and costs of ship construction are primarily denominated in the local foreign currency
- Operating costs for those ships unsold and carried as assets are primarily in the local foreign currency
- Cash outflows for operations and construction are principally in the local foreign currency
- There is no indication that the parent relies on the foreign entity for cash flow; earnings of the foreign entity are retained in the foreign country.

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In these particular circumstances, because the functional currency is not clearly identified, management judgment will be required to assess various factors that affect the economic results of the foreign entity to determine the currency that provides the most relevant and reliable measure of its day-to-day business.

Based upon the limited facts presented, we believe that the U.S. dollar or the local foreign currency could be the foreign entity's functional currency; management consideration of all economic facts and circumstances is required.

**Question No. 2: Worldwide Market for an Entity's Product.** Does the existence of a worldwide market for an entity's product (e.g., petroleum) evidence the appropriateness of using the reporting currency of the parent (generally the U.S. dollar) as the functional currency of a foreign entity?

**Response:** Paragraph 42b (2) of the Statement notes that sales prices that are determined by worldwide competition or are international prices would be a factor favoring the designation of the parent's currency as the functional currency. The FASB staff believes that the existence of a worldwide market for an entity's product would be a factor that supports the dollar being the functional currency; however, the FASB staff recognizes that all of the salient economic factors discussed in Appendix A, including the worldwide market for a product, must be considered in management's determination of the appropriate functional currency. We support the views of the FASB staff.

**Question No. 3: Intercompany Transactions.** A marketing subsidiary in a foreign country has a high volume of intercompany transactions with its parent company. Should the parent's currency be the functional currency?

**Response:** The high volume of intercompany transactions with the parent company supports the parent's currency as being the functional currency. However, the volume of intercompany transactions is only one of the factors to be considered in determining the appropriate functional currency. A complete evaluation by management must be made of all salient economic factors, both individually and collectively, in determining the functional currency.

**Question No. 4: Hedging Practices.** An entity located in a foreign country with a worldwide sales market for its product may have difficulty in designating a particular functional currency because the foreign entity may receive numerous foreign currencies on sale of its product. Can a foreign entity consider its hedging practices as a functional currency indicator?

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**Response:** Although the currency of denomination of hedging transactions is not specifically listed as a salient economic factor to be considered in the determination of the functional currency, Appendix A to the Statement states that other factors might be considered to be relevant in the determination of the appropriate functional currency. In this particular case, hedging practices, along with those factors discussed in Appendix A, should be considered by management in determining the functional currency. This consideration might result in designating the U.S. dollar as the functional currency if the entity's practice is to hedge all its other currency positions and commitments in U.S. dollars.

**Question No. 5: Distinct and Separable Operations.** What are the criteria that would indicate that a foreign entity might have more than one functional currency?

**Response:** Paragraph 7 of the Statement indicates that a foreign entity might have more than one functional currency if that entity has more than one distinct and separable operation. Therefore, *operations* that would be *distinct* and *separable* from one another within a foreign entity must exist before that foreign entity could determine that it has more than one functional currency. For example, two distinct operations would exist if a foreign entity has two divisions, one acting strictly as an agent for a domestic parent company in selling the parent's products in various international markets, while the other division has an entirely different line of products it manufactures and sells in local or regional markets.

**Question No. 6: Investment in a Joint Venture.** A foreign entity invests in a joint venture arrangement in another foreign country. The foreign entity will account for the investment using the equity method. The functional currency of the foreign entity for its other operations is the local currency. The joint venture manufactures locally but purchases most of its raw materials from other countries, including some from the investing entity. The joint venture sells locally. The joint venture will make distributions to the investors, based in two different foreign countries, on a current basis. The joint venture's life is limited to a fixed number of years. Could each investor determine that its local currency is the functional currency for the investment in the joint venture?

**Response:** Although all the other factors that would need to be considered in arriving at a factual determination of the functional currency are not described, the limited life of, and the current distribution of earnings by, the joint venture are factors that tend to support the designation of the foreign entity's functional currency as the functional currency of the investment in the joint venture. Under these circumstances, conceivably, each investor could conclude that its respective functional currency is the appropriate functional currency in which case each investor would have a different functional currency for the same joint venture.

## Remeasurement into the Functional Currency

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Under Statement No. 52, the process of going from a recordkeeping currency to the functional currency is called "remeasurement." The remeasurement process is accomplished by use of essentially the temporal method of Statement No. 8, whereby nonmonetary assets and liabilities are remeasured at the exchange rates in effect when they were first acquired and incurred.

Deferred income taxes and unamortized policy acquisition costs of a stock life insurance company are treated as monetary items and are remeasured at current exchange rates. Adjustments from the remeasurement process are included in determining income.

**Question No. 1: Deferred Income Taxes.** Under paragraph 34 of the Statement, is it necessary to give effect to the remeasurement of a foreign entity's deferred income taxes at the current exchange rate *in each year* if the financial statements are restated to conform to the provisions of Statement No. 52, or can the difference between the historical and current exchange rates be reported as an adjustment of the opening balance of retained earnings of the year in which this Statement is first *adopted*?

**Response:** Any differences between the historical exchange rates previously required for a foreign entity's deferred income taxes and the current exchange rates now required under Statement No. 52 are to be applied in restatement of the financial statements for each year restated similar to other provisions of the Statement.

The effect of remeasuring deferred income taxes as of the beginning of the year to which this Statement is *first applied* should be reported as an adjustment of the opening balance of retained earnings of that year.

## Highly Inflationary Economies

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The FASB has determined that the reporting currency will be designated as the functional currency for all enterprises operating in an economy where the inflation rate in the foreign economy, on a cumulative three-year basis, equals approximately 100 percent or more. The FASB's intention is that the definition of a *highly inflationary economy* be applied with judgment.

**Question No. 1: Determining Cumulative Inflation.** How should cumulative inflation over a three-year period be determined?

**Response:** Cumulative inflation over a three-year period should be computed on a compounded basis.

Paragraph 11 of the Statement defines a highly inflationary economy as one that has cumulative inflation of *approximately* 100 percent or more over a three-year period.

Accordingly, a simple average inflation rate of 25 percent a year would result in cumulative inflation on a compounded basis of more than 95 percent over three years, which could be considered highly inflationary since 95 percent approximates 100 percent. (A simple average inflation rate of 26 percent a year would result in cumulative inflation on a compounded basis of 100 percent over three years.)

Additionally, paragraph 109 of the Statement states that the trend of inflation might be as important as the absolute rate. A three year trend of 45 percent, 20 percent and 15 percent compounds to 100 percent, yet the related economy may not be considered to be highly inflationary because of the decreasing trend.

**Question No. 2: Determining the Three-year Period.** In determining the three-year cumulative rate of inflation, what three-year period should be used?

**Response:** The determination of the three-year cumulative rate of inflation should be made using the most current information available. Accordingly, the most recent three-year period, including the current year, if possible, should be used. In instances where published indices have not been currently updated through an entity's year end, consideration should be given to the trend of inflation affecting the entity and to the use of estimates of inflation rates through year end.

**Question No. 3: Determining the General Price Level Index.** What kind of index should be used to determine a given currency's cumulative three-year inflation rate?

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**Response:** We believe that a broad-based measure of general inflation similar to the U.S. CPI (Consumer Price Index) would be a practical measurement index. The Statement does not require, however, that a specific published index be used for measurements of general price levels in different countries.

**Question No. 4: List of Highly Inflationary Economies.** Does the FASB plan to publish a list of highly inflationary economies?

**Response:** We understand that the FASB does not intend to publish a list of highly inflationary economies. As noted above, a broad-based measure of general inflation similar to the U.S. CPI should be used. Based on a review of one such index, the Consumer Price Index Numbers - All Items index published monthly by the International Monetary Fund, we have determined that the following countries appear to have highly inflationary economies:

Argentina	Ghana	Somalia
Bolivia	Iceland	Turkey
Brazil	Israel	Uruguay
Chile	Nicaragua	Yugoslavia
Colombia	Peru	Zaire

In addition to these countries, the economies of Mexico, Korea, Jamaica, and Sudan appear to be close to a three-year cumulative inflation rate of 100 percent, and may be considered to be highly inflationary. Use of a different index or a different time frame might alter these conclusions.

We suggest that a review be made of the latest published indices available as of an entity's year end for any additional economies that may be at or near a three-year cumulative inflation rate of 100 percent.

**Question No. 5: Brazilian System of Monetary Correction and Adjustment.** Under the provisions of the revised exposure draft (dated June 30, 1981), financial statements of an entity operating in Brazil that had been adjusted by the Brazilian system of monetary correction and monetary adjustment could have been used as the functional currency financial statements of the Brazilian entity. Can this still be done under the provisions of Statement No. 52?

**Response:** No. Under the provisions of the Statement, since the operations in Brazil are deemed to be in a highly inflationary economy, the financial statements of the Brazilian entity must be remeasured as if the reporting currency were designated to be the functional currency, generally the U.S. dollar.



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The foreign entity's assets and liabilities are remeasured as if they originally had been accounted for as assets and liabilities of the parent company. Generally, monetary items would be translated at current rates and nonmonetary items at historical rates.

Revenue and expense items would be remeasured using the weighted average rates, except for amounts related to assets or liabilities that are translated at historical rates.

Gains and losses resulting from changes in exchange rates for any foreign entity whose functional currency is another country's currency are included in determining income (i.e., the recordkeeping currency must be remeasured into the functional currency).

Financial statements prepared using the Brazilian system of monetary correction and monetary adjustment would not conform to U.S. generally accepted accounting principles.

**Question No. 6: Change in Functional Currency.** When it is determined that an economy is considered to have become highly inflationary in years subsequent to initial adoption or is no longer considered highly inflationary, how should the change in functional currency be accounted for?

**Response:** The requirements of paragraphs 9 and 46 of the Statement apply when an economy first becomes highly inflationary. In such cases, translation adjustments for prior periods should not be removed from equity and the translated amounts for nonmonetary assets at the end of the prior period become the accounting basis for those assets in the period of the change and subsequent periods.

The Statement does not address the accounting for a change to a foreign functional currency when the economy of a country ceases to be highly inflationary. Some believe that the guidance contained in paragraphs 9 and 46 of the Statement concerning a change in the functional currency from the reporting currency to the local foreign currency should be applied.

## The Current Rate Method of Translation and the Accumulated Translation Adjustment Account

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Under the *net investment concept* of the Statement, the reporting entity is viewed as having an investment in a foreign business whose foreign currency earnings, derived from operations in the local foreign economic, legal, and political climate, accrue to the benefit of the reporting entity in the amount of the U.S. dollar equivalent of those foreign currency earnings. Under this concept, all of the foreign entity's assets and liabilities are translated from that entity's functional currency into the reporting currency (generally the U.S. dollar) by using the current exchange rate. Increases or decreases in net assets (adjustments) resulting from changes in the exchange rate between balance sheet dates are not included in income, but are accumulated and reported as a separate component of stockholders' equity. Revenue, expense, gain and loss items are translated at the exchange rate at the time these items are recognized. For practical purposes, a weighted average exchange rate for the period may be used. Adjustments resulting from changes between the weighted average rate used for income statement purposes and the rate at the balance sheet date are accumulated and similarly reported in the separate component of stockholders' equity.

The amount included in the accumulated translation adjustment equity account attributable to a foreign entity is to be included in determining income in the period when a sale or complete, or substantially complete, liquidation of that foreign entity occurs. When these events occur, the adjustment is to be removed from the separate component of stockholders' equity and reported as part of the gain or loss on sale or liquidation of the investment.

### **Question No. 1: Investments Carried at Equity—General Procedures.**

What procedures are to be followed in connection with the accounting for an investment in a foreign entity that is carried on the equity method?

**Response:** The functional currency of the investee would have to be determined and the financial statements of the investee conformed to U.S. generally accepted accounting principles.

Where the functional currency is other than the recordkeeping currency of the investee or where the investee operates in a highly inflationary economy, then the financial statements would be remeasured into the functional currency (or the investor's reporting currency in certain cases) with the remeasurement gains or losses included in determining income.

The foreign entity's functional currency financial statements would then be translated into the investor's reporting currency using the current rate method including the reporting of translation adjustments in a separate component of stockholders' equity. The equity method would be applied to the reporting currency translated amounts and a proportionate share

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of the investee's income and change in the accumulated translation adjustment account would be recorded by the investor.

Thus, in situations when the financial statements of the investee must be remeasured into the investee's functional currency or when the investee operates in a highly inflationary economy, the adjustments arising from remeasurement will be included in determining income.

**Question No. 2: Investments Carried at Equity — Translation Adjustment Account.** If an investor accounts for an investment in a foreign entity using the equity method, will an entry be required on the investor's books to record an appropriate translation adjustment account?

**Response:** The Statement does not specify the entries that must be made in applying the equity method. The Statement does require, however, that if an investor accounts for an investment in a foreign entity using the equity method, the investor's financial statements should report an appropriate accumulated translation adjustment as a separate component of stockholders' equity.

**Question No. 3: Goodwill and Other Fair Value Adjustments.** Are goodwill and other fair value adjustments arising in a business combination accounted for by the purchase method related to a foreign entity considered to be assets of the foreign entity and part of the parent's net investment in that foreign entity?

**Response:** Yes. Paragraph 101 of the Statement indicates that goodwill and other fair value adjustments are treated as assets of the foreign entity as well as part of the parent's net investment in that foreign entity, and should be considered to be denominated in the functional currency of that foreign entity. Therefore, goodwill and other fair value adjustments would be translated at the current exchange rate if the local foreign currency is the functional currency of the foreign entity.

**Question No. 4: Sale or Liquidation of an Investment.** Is a transfer from the accumulated translation adjustment account to income triggered by:

- a. Payment of an annual dividend equivalent to income?
- b. Payment of a liquidating dividend?
- c. Partial sale of an investment in a foreign entity?
- d. Reclassification or payment of intercompany accounts that were previously considered part of the net investment in the foreign entity?

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- e. The sale of a significant portion (perhaps 90 percent) of the operating assets of a foreign entity? (Does the sale of a significant portion of the operating assets constitute a substantially complete liquidation?)
  - f. The sale for cash of all significant operating assets of a foreign entity with the proceeds reinvested in certificates of deposit or interest-bearing securities? (Is such a sale and reinvestment a liquidation?)

**Response:**

- a. No.
- b. If the liquidating dividend results in substantially complete liquidation of the foreign entity, yes. Otherwise, no.
- c. No, unless the magnitude of the sale is equivalent to substantially complete liquidation.
- d. Generally no, but if payment or reclassification is tantamount to substantially complete liquidation, yes.
- e. Yes, although the FASB does not provide any guidance in the Statement concerning what constitutes substantially complete liquidation. We believe that ordinarily a sale of 90 percent of the operating assets would constitute a substantially complete liquidation.
- f. Yes. Where all significant operating assets have been sold for cash and the proceeds reinvested in certificates of deposit or interest-bearing securities, we believe that, in substance, a liquidation usually has occurred. Consideration would need to be given to the use of the proceeds in making a final determination as to whether a liquidation has occurred.

**Question No. 5: Dividend Remittance Rate.** What are the "unusual circumstances" referred to in paragraph 27(b) of the Statement in which the rate applicable to dividend remittances would not be used?

**Response:** The unusual circumstances referred to in paragraph 27(b) of the Statement generally relate to situations in which different rates apply for investments and dividend remittances — such as in South Africa.

**Question No. 6: Effect of Current Rate Method on Depreciation Expense.** Will the change in the translation rate for property, plant and equipment from a historical rate under Statement No. 8 to a current rate under Statement No. 52 change the depreciation expense from what would have been reportable under Statement No. 8?

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**Response:** The property, plant and equipment accounts are depreciated over their normal lives in the functional currency. The resultant depreciation expense is then translated to the reporting currency at the current (weighted average) exchange rate. This change of translation rates will result in depreciation expense different from what would have been reported under Statement No. 8.

Under the current rate method, when the functional currency appreciates in relation to the reporting currency, the cumulative translated amounts of depreciation expense could exceed the historical cost of the plant.

**Question No. 7: Statement of Changes in Financial Position.** What guidance is given in Statement No. 52 on the preparation of the statement of changes in financial position?

**Response:** The original exposure draft did not address the statement of changes in financial position. The revised exposure draft gave specific guidance that in certain situations may have required the preparation of a separate statement of changes in financial position for each foreign subsidiary and separate disclosure of the effect of the change in exchange rates on working capital. The actual standards of Statement No. 52 do not contain any guidance concerning the treatment of translation adjustments in the statement of changes in financial position. Paragraph 100 of the Statement, however, refers to APB Opinion No. 19, *Reporting Changes in Financial Position*, noting that the Opinion requires disclosure of all important changes in financial position.

The revised exposure draft (dated June 30, 1981) would have required changes in financial position to be translated by using the current exchange rate at the end of a reporting period, except for changes resulting from revenues, expenses, gains and losses that had to be translated generally at a weighted average exchange rate. Although there is no specific guidance in the final Statement, this method would be acceptable.

Another method that we believe would be acceptable is the presentation of the effect of exchange rate changes on the more significant assets and liabilities of foreign entities, including property, plant and equipment, investments and long-term debt. The impact of the current rate method of translation on non-current assets such as property, plant and equipment and investments may lead enterprises to conclude that the effect of exchange rate changes on at least significant assets and liabilities should be disclosed.

## Intercompany Foreign Currency Transactions

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Gains and losses arising from the translation of *intercompany foreign currency transactions* that are of a *long-term investment nature* (that is, settlement is not planned or anticipated in the foreseeable future) should not be included in determining income. Such amounts should be reported in the same manner as adjustments arising from the translation of financial statements of a foreign entity.

Gains and losses arising from the translation of intercompany foreign currency transactions that are not of a long-term investment nature should be included in determining income, unless such transactions are designated as, and are effective as, a hedge of a net investment in a foreign entity or a hedge of a foreign currency commitment.

### **Question No. 1: Nature of a Long-term Intercompany Investment.**

For an undercapitalized foreign entity, how is the portion of intercompany balances representing an investment of a long-term nature determined?

**Response:** The capitalization of a foreign entity has no bearing on the determination of what may be considered to be a long-term intercompany investment transaction.

The determining factor, according to paragraph 20(b) of the Statement, is whether settlement of the transaction is planned or anticipated in the foreseeable future, and paragraph 131 of the Statement states that investments of a long-term investment nature might include balances that take the form of an advance or a demand note payable provided that payment is not planned or anticipated in the foreseeable future. Accordingly, a long-term intercompany investment may take the form of long-term debt or another non-equity type of cash transfer, provided that settlement is not planned or anticipated in the foreseeable future.

Gains and losses on such long-term intercompany investments are to be reported in the same manner as translation adjustments (namely, in the separate component of stockholders' equity) provided, however, that the financial statements are consolidated, combined, or accounted for by the equity method.

Gains or losses on intercompany transactions and balances with a non-consolidated subsidiary or investee that is not accounted for by the equity method could not be treated by a parent company in the same manner as translation adjustments.

**Question No. 2: Clarification of Foreseeable Future.** Would an intercompany loan repayable at the end of 20 years be considered of a long-term investment nature? 50 years? What is foreseeable future?



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**Response:** Foreseeable future does not imply a specific time period. Whether repayment is *presently* planned or anticipated at any date in the future is the key factor. Management intent is highly important in reaching a determination of whether a particular intercompany balance is of a long-term investment nature.

We suggest that management document its intention with respect to each intercompany transaction and balance that is considered to be of a long-term investment nature.

**Question No. 3: General Comments.** How do you account for transactions that are not of a long-term investment nature between foreign subsidiaries and parent companies?

**Response:** Assuming that the local currency of a foreign entity is the functional currency, in general, intercompany transactions that are denominated in the local currency of the foreign entity would result in a translation adjustment of the foreign entity's financial statements in the U.S. dollar reporting currency for any change in the exchange rate and would be reported in the cumulative translation adjustment component of stockholders' equity.

On the other side of such transactions, the parent company, in determining income, would recognize a foreign exchange gain or loss on its books for any change in the exchange rate, except for foreign currency transactions that are designated as, and are effective as, economic hedges of a net investment in a foreign entity or hedges of a firm foreign currency commitment.

Assuming that the local currency of a foreign entity is the functional currency, where intercompany transactions are denominated in the U.S. dollar reporting currency of the parent company, the foreign entity, in determining income, would recognize a foreign currency transaction gain or loss in each period in which the exchange rate changes. The parent company would not record a gain or loss on its books because the transaction is denominated in U.S. dollars.

**Question No. 4: Settlement of Intercompany Transactions Not Previously Planned or Anticipated.** If an intercompany transaction is settled for which settlement was not previously planned or anticipated, what is the appropriate disposition of the applicable amount included in the translation adjustment account?

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**Response:** If a transaction is settled for which settlement was not planned or anticipated, the cumulative translation adjustment amount included in the separate component of stockholders' equity applicable to the period for which settlement was not planned or anticipated should remain in the separate component of stockholders' equity unless settlement of the transaction represents a complete or substantially complete liquidation of the foreign entity.

**Question No. 5: Dividends Receivable.** If a subsidiary declares a dividend to its parent, and there is a significant time lag between record date and payment date, what is the disposition of the translation gain or loss related to the parent's dividends receivable account?

**Response:** Assuming the local currency of the foreign entity is the functional currency, the translation adjustment from the dividend payable would be included in the separate component of stockholders' equity. Further, assuming settlement of the dividend is anticipated in the foreseeable future, the translation adjustment on a dividend receivable account should be included in determining income in the parent's financial statements.

**Question No. 6: Parent or Subsidiary Can Initiate Intercompany Transaction.** Paragraph 20(b) of the Statement provides that transaction gains or losses be reported in the separate component of stockholders' equity if they relate to intercompany foreign currency transactions that are considered to be of a long-term investment nature. Is this accounting appropriate regardless of which entity to the transaction initiated the "foreign currency transaction?"

**Response:** Yes.

**Question No. 7: Presentation in Separate Financial Statements of Foreign Entity.** If paragraph 20(b) of the Statement applies to an intercompany transaction, how should the gain or loss be presented in the separate financial statements of a foreign entity (i.e., in equity or in determining income)?

**Response:** Generally, the transaction gain or loss on intercompany transactions would be included in determining income in the separate financial statements of a foreign entity.

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**Question No. 8: Aggregation of Intercompany Transactions.** Is the nature of intercompany transactions to be based on looking at the individual receivables or payables or at the balance of a group of receivables or payables? Also, does accounting for payments of intercompany balances on a LIFO basis so that certain older invoices will not be "paid" in the foreseeable future qualify those balances for treatment as long-term investment nature?

**Response:** The "group view" would allow a conclusion that even though the individual receivables and payables are settled, the fact that a constant level is maintained allows the group of transactions to be considered a long-term investment item. The FASB staff believes that intercompany transactions should be considered on an individual basis and that the aggregate balance of a group of trade receivables or payables (each open invoice will be settled) cannot qualify as a long-term investment. Also, accounting for payments of intercompany balances on a LIFO basis cannot qualify as a long-term investment. We support the FASB staff's views.

Management could, however, where appropriate, designate intercompany amounts used to finance working capital of a foreign entity as a long-term investment if the intent is that payment not be made in the foreseeable future. Obviously tax implications of such a designation would need to be considered.

## Hedging

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Accounting for forward exchange contracts has not been changed from the provisions of Statement No. 8, but the rules for consideration of such contracts as hedges have been liberalized. A forward contract or other foreign currency transaction may be considered to hedge an identifiable foreign currency commitment if the following conditions are met:

- The foreign currency transaction is designated as, and is effective as, a hedge of a foreign currency commitment and
- The foreign currency commitment is firm.

The required accounting is to commence as of the designation date. The amount of the hedging transaction that is to be accounted for as a hedge is limited to the amount of the related commitment, on an after-tax basis. The amount of gain or loss deferred attributable to deferred income taxes is to be used as an offset to the related tax effects in the period in which the tax effects are recognized. Additionally, a foreign currency transaction may be designated as, and be effective as, an economic hedge of a net investment in a foreign entity.

**Question No. 1: Firm Commitments.** Statement No. 52 does not define "firm commitment." Can estimated amounts payable or receivable under a contract be hedged?

**Response:** Statement No. 52 does not require that a commitment be "noncancelable" to be considered "firm." Accordingly, estimated amounts receivable or payable under contractual agreements may be hedged, provided execution of the commitment is probable and amounts are reasonably estimable.

**Question No. 2: Intercompany Transactions.** Can an intercompany transaction be a hedging transaction? (Example: U.S. parent company "P" has two subsidiaries, French subsidiary "F" and Canadian subsidiary "C", both with their local currencies being their functional currencies. F lends money to C, denominated in francs. Can P designate that borrowing as a hedge of P's net investment in F?)

**Response:** An intercompany transaction can be accounted for as a hedging transaction provided it meets the hedge criteria (i.e., it is designated as and is effective as a hedge). In the example cited, in order for the intercompany transaction to be effective as a hedge, there must be a correlation between movement of the exchange rates between the U.S. dollar and the franc and the Canadian dollar and the franc. While a review of prior exchange rate movements may provide some assurance that such currencies do move in tandem, the effectiveness of the hedge is dependent upon a continuation of the historical pattern. As a result, in such situations the effectiveness of the hedge must be verified retroactively.

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**Question No. 3: Effectiveness of a Hedge.** How and when is the “effectiveness” of a hedge determined?

**Response:** The “effectiveness” of a hedge should be evaluated not only at the time it is designated, but also on an ongoing basis throughout the period of the hedge. The only criterion for evaluating the ultimate effectiveness of the hedge is the actual results. For example, if a transaction that was expected to produce a transaction gain to offset a translation loss instead produces a transaction loss, it is not effective and cannot be accounted for as a hedge for that period despite prior designation.

**Question No. 4: Designation of a Hedge of a Net Investment.** Can designation of a transaction as a hedge of a net investment be made, removed, and subsequently remade?

**Response:** Yes. Accounting for a hedge commences as of the designation date(s). Designation after the transaction date (or counter designation) does not constitute an accounting change.

**Question No. 5: Hedging in a Currency that Moves in Tandem With Another Currency.** The Statement provides that if it is not practical or feasible to hedge in the currency in which a commitment or net investment is denominated, then another currency that generally moves in tandem with the first currency could be used for hedging transactions. Does this mean that it must be shown that to hedge in the currency of denomination is not practical or feasible before an effective hedge in another currency can be accounted for as a hedge?

**Response:** The FASB staff believes that, generally, it must be shown that hedging in the currency in which a net investment or commitment is designated is not practical or feasible for hedging in another currency to be acceptable. A past history of parallel exchange rate changes and an anticipation that that movement will continue would indicate that a particular currency moves in tandem with another currency. We support the FASB staff’s views.

**Question No. 6: Foreign Currency Commitment.** Can one entity hedge a transaction of another entity under Statement No. 52?

**Response:** A foreign currency transaction of one entity generally may hedge a commitment of another entity under the Statement, provided the hedged commitment is a foreign currency commitment to the entity that entered into it. For example, to meet the provisions of paragraph 21 of the Statement, a U. S. parent generally would not hedge a commitment of a subsidiary that is denominated in the subsidiary’s functional currency. However, the parent could hedge the commitment of the subsidiary if the commitment was denominated in a currency other than the functional currency of the subsidiary with the commitment.

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**Question No. 7: Anticipated Cash Flows.** Can anticipated cash flows (e.g., uncommitted sales or future net income) be treated as foreign currency commitments, with gains or losses on offsetting hedges deferred?

**Response:** Anticipated cash flows that do not represent firm, identifiable commitments may not be treated as hedged commitments.

**Question No. 8: Documentation of a Hedge Designation.** How do you “designate” a transaction as a hedge?

**Response:** Designation as a hedge involves taking some overt, documented action as evidence of intent to hedge.

**Question No. 9: Hedged Commitment Not Completed.** What happens if a hedged commitment is not completed?

**Response:** If a hedged commitment is not completed, any deferred gain or loss on the hedging transaction should be included in determining income.

**Question No. 10: Economic Hedge of a Net Investment.** Paragraph 20(a) of the Statement refers to economic hedges of a net investment in a foreign entity. Paragraph 129 of the Statement presents an example that relates to accounting hedges. Does the FASB intend hedges to be only related to reported carrying amounts of assets and liabilities in the financial statements and any excess from the hedging transaction on translation gain or loss included in determining income for each reporting period?

**Response:** The intent of the FASB is that the term “economic hedge” relates to management of the accounting aspects of an exposure (i.e., the carrying amounts of the assets and liabilities as reported in the financial statements of an entity) rather than the fair market value of an investment in an entity.

Accordingly, any gain or loss pertaining to the portion of a hedging transaction that is in excess of the amount that provides a hedge on an after-tax basis for reported amounts shall not be deferred. This means that in each accounting period the gain or loss on the excess must be included in determining income.



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**Question No. 11: Hedging Contracts.** In practice, since hedge contracts in many cases are entered into for periods of six to twelve months, net investment exposure for hedging purposes is calculated based on mid-year balances that include one-half of the projected yearly earnings. Therefore, it is not uncommon to be overhedged for the first six months and underhedged for the last six months. Would hedge gains in excess of translation losses arising from the above-mentioned situation be reported in current earnings?

**Response:** Generally any excess must be reported for each accounting period as a foreign currency gain or loss in determining income, except that excess which is intended to provide a hedge on an after-tax basis. The gain or loss on that excess is deferred and included as an offset to the related tax effects in the period in which such tax effects are recognized.

**Question No. 12: Hedging of Net Investments in Highly Inflationary Economies.** Is it possible to enter into a transaction to hedge a net investment in an entity operating in an economy experiencing high inflation?

**Response:** Since the reporting currency is designated as the functional currency of an entity operating in an economy experiencing high inflation, the net investment in that entity would not be considered a foreign currency investment. As a result, if the investor entered into a transaction denominated in the currency of the highly inflationary economy, the related translation adjustments would be included in determining income.

## Disclosure and Transition

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Required disclosures include the following:

- The aggregate transaction gain or loss (including gains or losses on forward contracts) included in determining income;
- An analysis of the changes during the period in the accumulated translation adjustment component of stockholders' equity; and
- Rate changes occurring after the date of the financial statements and their effect on unsettled foreign currency transaction balances, if significant, may be necessary.

The Statement is effective for fiscal years beginning on or after December 15, 1982. Earlier application is encouraged.

Financial statements for periods before the effective date and financial summaries or other data derived from the statements may be (but are not required to be) restated.

The effect of adopting the Statement on income before extraordinary items, net income and related per share amounts for the year of adoption must be disclosed if an entity first adopts the standard for a fiscal year ending on or before March 31, 1982.

**Question No. 1: Adoption of Statement for Fiscal Years Ending On or Before March 31, 1982.** Paragraph 37 of the Statement requires companies that first adopt the Statement for fiscal years ending on or before March 31, 1982 to make "as if" disclosures of certain amounts for the year of the change. This disclosure is required whether or not retroactive application is elected. Must the disclosure be repeated in subsequent annual reports?

**Response:** Paragraph 37 of the Statement requires companies that first adopt the Statement for fiscal years ending on or before March 31, 1982 to make "as if" disclosures for the year of the change. This disclosure is required whether or not retroactive application is elected. The FASB staff believes that the disclosure need not be repeated in subsequent annual reports. We support the FASB staff's view.

**Question No. 2: Exchange Rate Changes Subsequent to the Balance Sheet Date.** Paragraph 32 of the Statement states that disclosure of a rate change occurring after the balance sheet date and its effects on unsettled balances pertaining to foreign currency transactions, if significant, may be necessary. Would this provision require any disclosure in the absence of unsettled foreign currency transactions?

**Response:** No.

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**Question No. 3: Aggregate Transaction Gain or Loss.** Should the disclosure of the aggregate transaction gain or loss included in determining income required by paragraph 30 of the Statement be before or after income taxes, or both?

**Response:** Disclosure of the aggregate transaction gain or loss included in determining income required by paragraph 30 of the Statement should be before income taxes, although presentation of the effect on both a pre-tax and after-tax basis would be permitted.

**Question No. 4: Existing Hedges Upon Initial Adoption.** When the Statement is first adopted, can existing economic hedges not recognized under Statement No. 8 be accounted for in accordance with the provisions of Statement No. 52?

**Response:** An economic hedge existing before the issuance of the Statement can be designated as a hedge as part of initial application of the Statement, provided the hedge is effective and there is evidence of intent to hedge. However, for hedges entered into after the issuance of the Statement, hedge accounting should be applied only upon designation (i.e., not retroactively designated).

**Question No. 5: Restatement of Data in SEC Filings.** Will data for prior years included in supplemental schedules and quarterly data in SEC filings have to be restated if the financial statements of those prior years are restated to conform to the provisions of Statement No. 52?

**Response:** All data for prior years included in supplemental schedules must be restated in the year in which the Statement is first adopted if they are affected by the restatement of the financial statements.

Likewise, required quarterly financial data presented for the current and prior years will have to be restated in the year of adoption if restatement is elected. Even if restatement is not elected, in the year of adoption of the Statement, quarterly data would require restatement if the election were not made in the first quarter. For example, if early adoption were made in the fourth quarter of calendar year 1981, the first three quarters of 1981 would require restatement.

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**Question No. 6: Form 10-Q Information.** If an entity adopts Statement No. 52 in 1981, thus necessitating a restatement of quarterly information for the first three quarters, does restatement require filing amendments to the Form 10-Qs filed with the SEC for such quarters?

**Response:** The Form 10-Qs previously filed for the first three quarters of 1981 do not have to be amended. Where comparative amounts are required in current filings or where quarterly data is required in annual reports, such amounts must be restated.

**Question No. 7: Management Discussion and Analysis.** If Statement No. 52 is adopted without restating prior years, what explanations would be required in management discussion and analysis?

**Response:** The Statement permits, but does not require, disclosure of income before extraordinary items and net income for the prior year computed on a pro forma basis, if the prior year is not restated. Although there is no explicit requirement in the SEC's rules covering this situation, we would encourage management to consider including such pro forma amounts in management discussion and analysis to make such presentation more meaningful.

## Miscellaneous Issues

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**Question No. 1: Discontinued Operations.** Paragraph 14 of the Statement states that the translation adjustment component attributable to a foreign entity is removed from stockholders' equity upon sale or complete, or substantially complete, liquidation of that foreign entity. Is it correct to assume that the timing of loss and gain recognition should be determined using the provisions of FASB Statement No. 5, *Accounting for Contingencies*, and APB Opinion No. 30, *Reporting the Results of Operations*?

**Response:** The timing of gain and loss recognition should be determined using the provisions of FASB Statement No. 5 and APB Opinion No. 30. Further, when a provision for a discontinued segment is required under APB Opinion No. 30, the component of the translation adjustment account related to the segment (if the segment constitutes a separate and distinct foreign entity) should be included in the computation of the gain or loss on the discontinuance of the segment.

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